FILED

961127 JAN 15 1997

OFFICE OF THE CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

EXXON CORPORATION AND SUBSIDIARIES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

WALTER DELLINGER
Acting Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

KENT L. JONES
Assistant to the Solicitor General

BRUCE R. ELLISEN
THOMAS J. CLARK
Attorneys
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTION PRESENTED

Sections 611 and 613 of the Internal Revenue Code authorize a percentage depletion deduction for producers of oil and gas that is equal to 22 percent of the producer's "gross income from the property" (26 U.S.C. 613). The question presented in this case is:

Whether a producer who has transported or processed natural gas before it is sold may compute the percentage depletion deduction for such sales based upon a representative price received by other producers in the same field when that representative price exceeds the producer's actual "gross income from the property."

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	2
Statutes and regulation involved	2
Statement	4
Reasons for granting the petition	10
Conclusion	23

TABLE OF AUTHORITIES

Cases:

Bowen v. *Georgetown Univ. Hospital*, 488 U.S. 204 (1988)	18
Bowles v. *Seminole Rock & Sand Co.*, 325 U.S. 410 (1945)	17
Chevron U.S.A. Inc. v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)	17
Consumers Natural Gas Co. v. *Commissioner*, 78 F.2d 161 (2d Cir.), cert. denied, 296 U.S. 634 (1935)	13
Crews v. *Commissioner*, 89 F.2d 412 (10th Cir. 1937)	21, 22
Exxon Corp. v. *Commissioner*, 102 T.C. 721 (1994)	5, 12, 15, 16, 17, 19, 20
Ford Motor Credit Co. v. *Milhollin*, 444 U.S. 555 (1980)	17, 18
Helvering v. *Mountain Producers Corp.*, 303 U.S. 376 (1938)	21
Helvering v. *Twin Bell Oil Syndicate*, 293 U.S. 312 (1934)	21
Lyng v. *Payne*, 476 U.S. 926 (1986)	18
Martin v. *Occupational Safety and Health Review Commission*, 499 U.S. 144 (1991)	18
Panhandle Eastern Pipe Line Co. v. *United States*, 408 F.2d 690 (Ct. Cl. 1969)	13
Shalala v. *Guernsey Memorial Hospital*, 115 S. Ct. 1232 (1995)	17

Cases—Continued: Page

Smiley v. *Citibank (South Dakota), N.A.*, 116 S. Ct. 1730 (1996) 16, 18
Udall v. *Tallman*, 380 U.S. 1 (1965) 17, 22
United States v. *American Bar Endowment*, 477 U.S. 105 (1986) 11
United States v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960) 12-13, 20, 21
United States v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989) 11, 23
United States v. *Henderson Clay Products*, 324 F.2d 7 (5th Cir. 1963), cert. denied, 377 U.S. 917 (1964) 13, 22
United States v. *Hill*, 506 U.S. 546 (1993) 11, 23

Statutes and regulations:

Internal Revenue Code of 1954 (26 U.S.C.):
§ 61(a) 21, 22
§ 611 (1970) 2, 4, 8, 9, 11
§ 611(a) (1970) 2, 4, 5, 11
§ 611(b) (1970) 5, 11
§ 613 (1970) 2
§ 613(a) (1970) 2-3, 11, 14, 19, 20
§ 613(b) (1970) 3, 11, 19
§ 613(c) (1970) 3-4
§ 613A 5
§ 613A(b)(3) 5
§ 613A(c) 5
Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26:
§ 501, 89 Stat. 47 5
Treas. Reg. 74, Art. 221(i) 12
Treasury Regulations on Income Tax (26 C.F.R.):
Section 1.613-3 (1974) 4
Section 1.613-3(a) (1974) 4, 5, 6, 12, 13, 15, 20

Miscellaneous:

Hearings Before the Joint Committee on Internal Revenue Taxation, 71st Cong., 3d Sess. (1930) .. 12
Rev. Rul. 90-62, 1990-2 C.B. 158 ..... 14, 17

In the Supreme Court of the United States

OCTOBER TERM, 1996

No.

UNITED STATES OF AMERICA, PETITIONER

v.

EXXON CORPORATION AND SUBSIDIARIES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-32a) is reported at 88 F.3d 968. The first opinion of the Court of Federal Claims (App. 33a-84a) is unreported. The second opinion of the Court of Federal Claims (App. 85a-171a) is reported at 33 Fed. Cl. 250.

JURISDICTION

The judgment of the court of appeals was entered on June 20, 1996. A petition for rehearing was denied on September 17, 1996 (App. 172a-173a). On December 6, 1996, the Chief Justice extended the time for filing a petition for a writ of certiorari to January 15, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATION INVOLVED

1. Section 611 of the Internal Revenue Code of 1954, 26 U.S.C. 611, as in effect for the year 1974, provided in relevant part:

> (a) **General rule.**—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c).
> * * *

2. Section 613 of the Internal Revenue Code of 1954, 26 U.S.C. 613, as in effect for the year 1974, provided in relevant part:

> (a) **General rule.**
>
> In the case of mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross

income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). * * *

(b) **Percentage depletion rates.**

The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) **22 Percent.**

(A) oil and gas wells:

* * * * *

(c) **Definition of gross income from property.**

For purposes of this section—

(1) **Gross income from the property.**

The term "gross income from the property" means, in the case of a property other than an oil or gas well, the gross income from mining.

(2) **Mining.**

The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes

> are applied thereto as is not in excess of 50 miles unless the Secretary or his delegate finds that the physical and other requirements are such that the core or mineral must be transported a greater distance to such plants or mills.
>
> * * * * *

3. Section 1.613-3 of the Treasury Regulations on Income Tax, 26 C.F.R. 1.613-3, provides in relevant part:

> (a) *Oil and gas wells.* In the case of oil and gas wells, "gross income from the property", as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.
>
> * * * * *

STATEMENT

1. a. This case involves the proper application of the depletion allowance for producers of natural gas. In Section 611 of the Internal Revenue Code, Congress authorized "as a deduction in computing taxable income a reasonable allowance for depletion" of minerals, such as oil and gas (26 U.S.C. 611(a)). Since 1926, the depletion allowance for oil and gas has been based upon a percentage of the "gross in-

come from the property" (26 U.S.C. 611(a) and (b)).[1]

The pertinent Treasury regulation provides that "gross income from the property" means the revenue from the sale if the oil or gas is sold "in the immediate vicinity of the well." 26 C.F.R. 1.613-3(a). If the taxpayer does not sell the oil or gas on the premises, but manufactures or converts it into a refined product, or transports it prior to sale, the regulation provides that the gross income from the property "shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation" (*ibid.*).

b. Respondent engages in all phases of the oil and gas business, including exploration, production, processing, refining, transporting, marketing and retailing. Respondent is therefore known as a "fully integrated" producer of oil and natural gas. By contrast, a "nonintegrated" producer is focussed more

---

[1] The applicable percentage has been altered from time to time by Congress. The percentage depletion deduction for oil and gas was repealed by 26 U.S.C. 613A, which applies to tax years ending after 1974. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501, 89 Stat. 47. An exception is provided therein, however, for "natural gas sold under a fixed contract," which was defined, in part, as a contract in effect on February 1, 1975. 26 U.S.C. 613A(b)(3). By reason of this exception, respondent continued to claim the percentage depletion deduction for gas sold under its long-term contracts for a number of years after the enactment of Section 613A. See *Exxon Corp.* v. *Commissioner*, 102 T.C. 721, 733 (1994). Another exception is provided for independent producers and royalty owners. 26 U.S.C. 613A(c). The percentage depletion deduction thus remains available for many producers and their tax liability continues to be affected by the question presented in this case.

narrowly on exploration and production. A "non-integrated" producer typically sells natural gas in an unprocessed state at the well-head (App. 2a-3a, 63a).

From 1953 through 1972, respondent entered into a series of long-term natural gas sales contracts covering thousands of oil and gas wells located on hundreds of properties in East Texas and the Texas Gulf Coast (App. 3a, 62a, 72a, 77a). After processing the gas and transporting it from the immediate vicinity of the wells, respondent sold natural gas under these long-term contracts at an average price of $.23 per thousand cubic feet (mcf). These contract prices were competitive when initially negotiated. By 1974, however, the prices realized by respondent were well below then-current market prices (*id.* at 3a, 77a-78a).

The production involved in this case was not sold "in the immediate vicinity of the well" (26 C.F.R. 1.613-3(a)). Respondent therefore asserted that, under the applicable regulation, its "gross income from the property" should be "assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation" (*ibid.*). On its federal income tax return for 1974, respondent claimed that the representative market or field price of its gas was $0.36 per mcf. That figure yielded a "gross income from the property" that far exceeded the actual revenues that respondent received from its sales of this natural gas (App. 4a, 17a-18a).

c. On audit, the Internal Revenue Service determined that respondent was not permitted to use a representative market or field price in calculating its depletion deduction when that price exceeded the

actual gross income that respondent received from its sales of the gas. The Service used what it described as a "net-back" method to determine respondent's gross income from the property for depletion purposes. Under the "net-back" method, the actual gross revenues that respondent received for its sales of the natural gas and the hydrocarbon liquids processed from it ($.29 per mcf) were decreased by the transportation costs that respondent incurred in delivering the processed gas for sale (approximately $.02 per mcf). This adjustment yielded the actual "gross income" that respondent realized at the wellhead from its production of natural gas (approximately $.27 per mcf). Because the actual "gross income from the property" was far less than respondent claimed, the Service disallowed approximately $11,000,000 of the depletion deduction asserted by respondent. This adjustment increased the 1974 federal income tax liability of respondent by more than $5,000,000 (App. 4a, 79a-80a).

2. Respondent paid the asserted deficiency and brought this suit for a refund in the Court of Federal Claims. The court noted that, under the applicable regulation, the "representative market or field price" is "assumed" to be applicable in determining the "gross income" for depletion purposes for sales of natural gas away from "the immediate vicinity of the well" (26 C.F.R. 1.613-3(a)). The court stated that the "literal language" of this regulation supports the taxpayer's position that the "representative market or field price" governs the calculation of the depletion deduction even when that price exceeds the actual "gross income" realized from the property (App. 121a). The court further noted, however, that the statute authorizes only a "reasonable [depletion]

allowance in all cases to be made under regulations prescribed by the Secretary" (26 U.S.C. 611). The court concluded that the plain language of this statute bars the use of a "representative market or field price" to calculate the depletion deduction when that price is not "*reasonable* under the circumstances" (App. 122a).

Based upon the evidence submitted at trial, the court concluded that respondent had failed to prove a "representative market or field price" that was reasonable under the circumstances (App. 135a-170a). Respondent claimed at trial that the "representative market or field price" of natural gas similar to the gas it sold in 1974 was $.41 per mcf, which was $.05 per mcf higher than respondent had claimed on its tax return for that year (*id.* at 135a-138a). Respondent submitted testimony and data concerning 2,228 gas sales in 1974 in support of this assertedly "representative" price. The trial court found, however, that respondent failed to show that those sales took place before the gas had been processed (for the removal of water or the extraction of valuable liquid components of the natural gas stream) or before the gas had been transported away from "the immediate vicinity of the well" (*id.* at 153a). The court therefore held that respondent had failed to satisfy its burden of establishing a "representative market or field price" under the terms of the regulation (*ibid.*).

The court further determined that, even if respondent had proven a representative market or field price of $.41 per mcf, such a price would be unreasonable in the circumstances of this case and was therefore prohibited by the statute (App. 167a-170a). The court noted that "[t]he advantage Exxon

would gain by applying the [representative market or field price] of $.41 per Mcf, is *a depletion allowance of approximately $155,000,000 in excess of its actual income*" (*id.* at 170a (emphasis added)). The court concluded that the depletion allowance proposed by respondent violated the statutory requirement that only a "reasonable" allowance for depletion be permitted (26 U.S.C. 611) and would produce "an 'indigestible' result" that was "contrary to the legislative history of and purposes for the depletion deduction" (App. 170a).

3. The court of appeals reversed (App. 1a-32a). The court held that the statutory and regulatory scheme do not preclude use of a "representative market or field price" in excess of actual sales revenues (*id.* at 7a-17a). The court noted that no prior decision had "explicitly stated" that a "representative market or field price" in excess of actual gross income "is impermissible" (*id.* at 12a) and that there was "no language [in the applicable regulation] that expressly limits the RMFP [representative market or field price] to actual gross income" (*id.* at 13a). The court acknowledged that the "gross income" limitation on the depletion deduction is designed to serve two important objectives: (i) to ensure that the deduction is not used by a taxpayer to offset profits earned from a separate line of business; and (ii) to ensure that integrated producers do not obtain a competitive advantage over nonintegrated producers by including, in the "gross income from the property," any value that was *added* to the gas by processing or transportation (*id.* at 15a-16a). The court concluded, however, that (*id.* at 16a-17a):

> [t]he RMFP in the present case exceeds the actual gross income based on market forces and

> not based on downstream processing. While the legislative history addresses the effects of downstream processing, it is silent as to changes in market conditions. Contrary to the government's argument, therefore, we do not violate this statutory objective by refusing to limit the RMFP to actual gross income.

The court of appeals further held that the trial court had erred in concluding that a "representative market or field price" that was far in excess of actual "gross income" would be "unreasonable" and therefore in violation of the statute (App. 26a-29a). The court stated that "Congress has charged the Secretary with the task of promulgating regulations which yield a reasonable allowance" for depletion and "that a depletion allowance pursuant to Treas. Reg. § 1.613-3(a) is per se reasonable" (*id.* at 27a). The court stated that "our scope of review is limited to the reasonableness of the regulations and not the reasonableness of any individual allowance" (*id.* at 28a).

Finally, the court of appeals concluded that the trial court had erred in holding that respondent had failed to prove a representative market or field price. The court of appeals held that the evidence produced by respondent, which the trial court had refused to credit, established a "representative market or field price" of $0.39 per mcf (App. 25a).

REASONS FOR GRANTING THE PETITION

This case presents a question of significant, recurring fiscal importance. Respondent has raised the issue presented in this case in a series of lawsuits and audits that involve several different tax years. The taxes at issue in these several years exceed $1

billion. The correct disposition of this question with respect to respondent alone thus has a significant impact on the public fisc. Moreover, in reliance on the decision of the Federal Circuit in this case, other taxpayers can be expected to assert similar claims for inflated depletion deductions.

Because the Federal Circuit is a court of nationwide jurisdiction and because all taxpayers are entitled to pay the tax and sue for a refund within the Federal Circuit, it is unlikely that other courts of appeals will have an opportunity to review this same issue in subsequent cases. In similar circumstances, this Court has recognized the need for plenary review of Federal Circuit decisions of significant fiscal importance. See, *e.g.*, *United States* v. *Hill*, 506 U.S. 546, 549 (1993); *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132, 138 (1989); *United States* v. *American Bar Endowment*, 477 U.S. 105, 109 (1986). Such review is appropriate in this case.

1. a. In Section 611 of the Internal Revenue Code, Congress authorized, "as a deduction in computing taxable income a reasonable allowance for depletion" of minerals, such as oil and gas, and further provided that "such reasonable allowance in all cases [is] to be made under regulations prescribed by the Secretary" (26 U.S.C. 611(a)). Since 1926, the depletion allowance for oil and gas has been based upon a percentage of the "gross income from the property" (26 U.S.C. 613(a), 613(b)) which, during the year involved in this case, was fixed by statute at 22 percent (26 U.S.C. 611(a) and (b) (1970)). See note 1, *supra*.

Acting under the authority Congress provided in Section 611, the Secretary of the Treasury has, since 1929, specified by regulation the method for deter-

mining the "gross income from the property" in the case of oil and gas wells (Treas. Reg. 74, Art. 221(i)). The regulation establishes the general rule that the gross income from the property is "the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well" (26 C.F.R. 1.613-3(a)). The regulation further provides, however, that, when "the oil and gas is *not* sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation" (26 C.F.R. 1.613-3(a) (emphasis added)).

The portion of the regulation that specifies that the "gross income" for gas "not sold on the premises" is "assumed" to be the "representative" price for wellhead sales of gas in the same "market or field" serves two related functions. First, it ensures that a taxpayer may not include in its depletable income any value that was added to the oil or gas *after* extraction by processing, conversion or transportation. See *Exxon Corp.* v. *Commissioner*, 102 T.C. 721, 733-734 (1994); *Hearings Before the Joint Committee on Internal Revenue Taxation*, 71st Cong., 3d Sess. 104, 111 (1930) (testimony of B.M. Bartholow, Special Assistant to the Secretary of the Treasury). Second, it seeks to ensure that integrated producers are not treated better than nonintegrated producers, who are to compute their depletable gross income based on actual wellhead sales receipts. See *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 87 (1960) ("in each of the three basic percentage depletion Acts the Congress indicated that integrated operators

should not receive preferred treatment"); *Panhandle Eastern Pipe Line Co.* v. *United States*, 408 F.2d 690, 700 (Ct. Cl. 1969) ("The Supreme Court [in *Cannelton*] determined that the Congressional objective in allowing depletion deductions was not to give the integrated processor a preference resulting in a competitive advantage over the nonintegrated producer."); *United States* v. *Henderson Clay Products*, 324 F.2d 7, 15 (5th Cir. 1963) (noting the "strong desire to afford no unfair tax advantage to the integrated producer vis-a-vis the non-integrated miners and manufacturers"), cert. denied, 377 U.S. 917 (1964).

The premise underlying the regulation is that the value that is added to oil or gas *after* it is produced—by processing it "into a refined product prior to sale" or by transporting it "from the premises prior to sale" (26 C.F.R. 1.613-3(a))—is not part of the "gross income" derived from the production of the mineral itself. The percentage depletion allowance provides a deduction based upon only the value of the mineral as it is produced, and thus depleted. Congress has not authorized any *depletion* deduction for the value that is *added* to that mineral after production through subsequent processing or transportation. See, *e.g.*, *Panhandle Eastern Pipeline Co.* v. *United States*, 408 F.2d at 716; *Consumers Natural Gas Co.* v. *Commissioner*, 78 F.2d 161, 161-162 (2d Cir.) ("we are not justified in injecting into the 'basis' [upon which the deduction is computed] the added value imparted to the output by work done upon it after it reaches the surface"), cert. denied, 296 U.S. 634 (1935). To ensure that a taxpayer may not include that added value from processing or transportation in its depletable gross income, the regulation

limits the definition of "gross income" for off-premises sales to the "representative market or field price" of similar oil or gas before processing, conversion or transportation.

b. In a formal interpretation that conforms to the lengthy and consistent administrative practice under this regulation, the Commissioner of Internal Revenue explained that the term "gross income from the property" can not exceed the revenues in fact received from the sale of the oil and gas. While the regulation specifies that a representative market or field price is to be "assumed" applicable for sales of natural gas "after it is removed from the premises," if the price at which the gas is actually sold by the producer "is *lower* than the [representative market or field price]," the actual price received—rather than the "assumed" price—is to be used in calculating the depletion deduction. Rev. Rul 90-62, 1990-2 C.B. 158, 159 (emphasis added).

The Service has thus formally interpreted its regulation to require use of the "representative market or field price" only when the price does not exceed the actual gross income that the producer received in selling its production. 1990-2 C.B. at 159. This interpetation conforms the text of the regulation with the text of the statute, which limits the deduction to a percentage of the "gross income" received from sale of the mineral (26 U.S.C. 613(a)).

2. In this case, however, the Federal Circuit held that the Internal Revenue Service incorrectly understood its own, 67-year-old legislative regulation. The court concluded that the statement in the regulation that a representative market or field price "shall be assumed" to apply to off-premises sales of oil and gas is clear and unambiguous. The court held that the

plain text of the regulation requires that the representative market or field price be "assumed" applicable in calculating the depletion deduction for off-premises sales of natural gas even when the taxpayer's actual gross income from such sales is substantially less (App. 12a-13a, 29a). The court therefore allowed Exxon to obtain a depletion deduction in this case based upon hypothetical income that it, in fact, did not receive.

By contrast, in an opinion entered in a prior case involving a different tax year of this same taxpayer, the Tax Court carefully reviewed the origin, history, and text of this legislative regulation and rejected the identical contentions advanced by respondent in this case. The Tax Court explained in *Exxon Corp.* v. *Commissioner*, 102 T.C. 721 (1994), that if respondent were permitted to base its percentage depletion on higher prices received in the market *by others* —but that respondent did not itself receive—respondent would "reap benefits not intended" by the statute or by the regulation. 102 T.C. at 737. The Tax Court noted that the regulatory language contains an inherent ambiguity, for the statement that a representative market or field price "shall be assumed" to apply (26 C.F.R. 1.613-3(a)) "to sales of gas away from the wellhead * * * d[oes] not discuss the circumstances under which it was or was not appropriate to apply an alternative method." 102 T.C. at 737-738; see also *id.* at 727 & n.10. The court explained that the history and text of the regulation reflect that it seeks only "to provide a means by which parties could ascertain what portion of the taxpayer's *proceeds* from the sale of transported gas were attributable to the wellhead" value of the production. *Id.* at 743. The court stated that it "clearly was not designed to create 'income from the property'

that far exceeded the taxpayer's [actual] proceeds" and that respondent therefore could not claim percentage depletion on a representative market or field price that exceeded the price that respondent in fact received. *Ibid.*[2]

This conflict in decisions warrants this Court's review. Because other issues affecting respondent's liability for the tax year involved in the Tax Court case remain pending, the Tax Court has not yet entered an appealable, final order in *Exxon Corp.* v. *Commissioner*, *supra*. In the absence of review by this Court, respondent may contend in future proceedings in the Tax Court case that the decision of the Federal Circuit in this case is binding. But, it is unquestionably the function of this Court, not the Federal Circuit, to resolve conflicting decisions on recurring, important questions of federal law.

3. The court of appeals erred in this case in failing to defer to the agency's formal interpretation of its own substantive regulation. Indeed, the court of appeals did not even acknowledge the existence of the agency's interpretive ruling. The court thus failed to adhere to this Court's admonition in *Smiley* v. *Citibank (South Dakota), N.A.*, 116 S. Ct. 1730, 1735 n.3 (1996), that it is "absurd to ignore the agency's current authoritative pronouncement of what [its regulation] means." The decision in this case thereby directly conflicts with decisions of this Court that hold that the "ultimate criterion" for the proper application of a substantive regulation is the

---

[2] In the present case, the court of appeals failed even to mention, much less to address, the decision and reasoning of the Tax Court in this related *Exxon* case involving the same issue in a different tax year of the same taxpayer.

agency's formal interpretation—and that the agency's interpretation is to be given "controlling weight." *Udall* v. *Tallman*, 380 U.S. 1, 16-17 (1965) (quoting *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 413-414 (1945)). See also *Shalala* v. *Guernsey Memorial Hospital*, 115 S. Ct. 1232, 1236 (1995); *Ford Motor Credit Co.* v. *Milhollin*, 444 U.S. 555, 565 (1980).

a. As the Tax Court correctly concluded in the parallel case involving respondent, the "plain text" of the regulation is inherently ambiguous. The fact that a particular price is to be "assumed" or presumed applicable under the regulation does not imply that this regulatory "assumption" or presumption is irrebutable. As the Tax Court stated, this language in the regulation does not refute the possibility that there are "circumstances under which it was * * * appropriate to apply an alternate method." *Exxon Corp.* v. *Commissioner*, 102 T.C. at 737-738; see also *id.* at 727 & n.10.

Because, as the Tax Court correctly concluded, the text of the regulation does not compel only one interpretation, the agency's formal interpretation of its substantive regulation should have been upheld. The Court had "long recognized that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984). As the Court has emphasized, "[w]hen the construction of an administrative regulation rather than a statute is in issue, deference is even more clearly in order." *Udall* v. *Tallman*, 380 U.S. at 16.[3]

[3] The fact that the agency ruling (Rev. Rul. 90-62, 1990-2 C.B. 158) was issued one year after this suit was commenced

The "agency's construction of its own regulations is entitled to substantial deference" (*Lyng* v. *Payne*, 476 U.S. 926, 939 (1986)), for "the power authoritatively to interpret its own regulations is a component of the agency's delegated lawmaking powers" (*Martin* v. *Occupational Safety and Health Review Commission*, 499 U.S. 144, 151 (1991)).

b. The agency's interpretation of the legislative regulation involved in this case is entitled to controlling weight because it is not "demonstrably irrational" (*Ford Motor Credit Co.* v. *Milhollin*, 444 U.S. at 565). In contrast to the decision of the court of appeals, the agency's interpretation conforms the text and meaning of the regulation with the text and object of the depletion provisions of the Code. The court of appeals acknowledged that the depletion provisions seek (i) to preclude a taxpayer from using the depletion deduction to offset profits from a separate line of business and (ii) to prevent integrated producers from gaining a competitive advantage over nonintegrated producers by including in their "gross income from the property" any value added by processing and transportation (App. 16a). The result

---

does not deprive the ruling of authoritative weight. See *Smiley* v. *Citibank (South Dakota), N.A.*, 116 S. Ct. 1730, 1733 (1996) (applying ordinary rule of deference to an agency regulation that was issued in response to litigation). The Court has explained that it "den[ies] deference 'to agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice.'" *Ibid.* (quoting *Bowen* v. *Georgetown Univ. Hospital*, 488 U.S. 204, 212 (1988)). But a formal ruling interpreting the agency's own substantive regulation is entitled to deference even if it was adopted in response to the litigation in which the ruling is to be applied. See *Smiley* v. *Citibank (South Dakota), N.A.*, 116 S. Ct. at 1733 & 1735 n.3.

reached by the court of appeals in this case, however, is at odds with both of these objectives.

(i) The facts of the case involving respondent's 1979 tax year provide a stark illustration of how the decision of the court of appeals contravenes the first of these two objectives of the depletion provisions. In that year, respondent's actual revenues from these same natural gas properties were $95,502,000. *Exxon Corp.* v. *Commissioner*, 102 T.C. at 723. Respondent claimed, however, that it was entitled to a depletion allowance of $109,017,036 based on a hypothetical "gross income" from these properties of $495,000,000. Respondent calculated that asserted depletion deduction based upon a representative market or field price for such gas. The Tax Court properly rejected this misapplication of the regulation, noting that there is "no indication that [26 C.F.R. 1.613-3(a)] was designed to create income that never existed in order to inflate a depletion deduction." *Id.* at 735.

Under the reasoning of the court of appeals, however, respondent's depletion deduction in 1979 would not only completely offset its gross income from the properties, it would also serve to offset income that respondent earned from entirely unrelated lines of business. Under the theory of the court of appeals, instead of obtaining a depletion deduction of *22 percent* of the actual gross income that respondent received in 1979 (26 U.S.C. 613(a) and (b)), respondent would obtain a depletion deduction equal to *114 percent* of its gross income from the properties in that year ($109 million deduction divided by $95 million in income). Such a result would directly contravene the statutory and regulatory objective of limiting the depletion deduction to the "gross income"

that is derived by the taxpayer from *production*, not from processing or transporting, oil and gas. *Exxon Corp.* v. *Commissioner*, 102 T.C. at 743.

(ii) The second important objective of the statutory and regulatory limitations on the depletion deduction is that integrated producers are not to receive treatment that is more favorable than the treatment afforded to nonintegrated producers who sell their production at the well-head (App. 16a). As this Court stated in *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. at 87, "in each of the three basic percentage depletion Acts the Congress indicated that integrated operators should not receive preferred treatment." See also pages 12-14, *supra*. The decision of the court of appeals in the present case, however, disregards that clear legislative purpose.

As gas prices rose in 1973 and 1974, many producers who were tied into long-term contracts were required to sell natural gas at below then-current market prices. A nonintegrated producer who was bound by such a contract was required—by the first sentence of 26 C.F.R. 1.613-3(a)—to compute its depletable gross income on the actual revenues that it received for its well-head sales of gas. Nonintegrated producers are thus, in this manner, prohibited from obtaining a depletion allowance based upon an amount that exceeds their actual "gross income from the property" (26 U.S.C. 613(a)).

Under the decision of the court of appeals, however, an integrated producer such as respondent would be allowed to compute its depletion allowance on a representative market or field price that is far in excess of that producer's actual gross receipts. The interpretation of the regulation adopted by the court of appeals thus confers a competitive advantage for

respondent over similarly-situated nonintegrated producers. By rejecting the agency's interpretation of this substantive regulation, the decision in this case directly conflicts with the admonition of this Court in *United States* v. *Cannelton Sewer Pipe Co.* that "integrated operators should not receive preferred treatment" under the percentage depletion allowance. 364 U.S. at 87.

c. The interpretation of this regulation by the agency—unlike the interpretation adopted by the court of appeals—also conforms the meaning of the term "gross income" in Section 613(a) of the Code with the definition of that term in Section 61(a) of the Code, 26 U.S.C. 61(a) ("gross income means all income from whatever source derived"). As this Court concluded in its earliest decisions concerning the depletion deduction, Congress used the term "gross income" in the depletion provisions in a manner consistent with this ordinary meaning of the term. See *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376, 382 (1938) ("[t]he term 'gross income from the property' means gross income from the oil and gas * * * and the term should be taken in its natural sense"); *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312, 321 (1934).

Because the term "gross income" is to be given its ordinary meaning, it can not include "proceeds of oil never received by the taxpayer and no part of which became subject to income taxation" (*Crews* v. *Commissioner*, 89 F.2d 412, 416 (10th Cir. 1937)).[4]

---

[4] The *Crews* case involved a situation in which royalty owners sought to compute depletion deductions on proceeds from the sale of oil and gas that they never received (because the proceeds had been misappropriated). The Tenth Circuit

As the court stated in *United States* v. *Henderson Clay Products*, 324 F.2d at 12, the suggestion that depletion may be taken by a taxpayer upon "fictitious gross income greatly in excess of its actual gross income" conflicts with this statutory definition and is thus "highly indigestible." Under the definition of "gross income" established in Section 61(a) of the Code, a producer's "gross income" for purposes of depletion can not include income that was not "derived" from its sales of natural gas.

d. The agency's formal interpretation of its substantive regulation conforms its terms to the controlling statutory text. The court of appeals fundamentally erred by permitting a depletion deduction based upon "fictitious gross income." The court of appeals also erred by failing to adhere to the decisions of this Court that require that "controlling weight" be given to the agency's interpretation of its own regulation (*Udall* v. *Tallman*, 380 U.S. at 16-17).

4. Respondent has raised the issue presented in this case in a series of lawsuits and audits that involve several different tax years. The taxes at issue in these several years exceed $1 billion. The determination of this question with respect to respondent alone thus has a significant impact on the public fisc. Moreover, in reliance on the novel interpretation of the regulation adopted by the Federal Circuit in this

---

held that the amounts never received were not "gross income" for purposes of computing the depletion deduction. Relying on the ordinary meaning of "gross income" (89 F.2d at 415), the court reasoned that "there should not be included in such gross income proceeds of oil never received by the taxpayer and no part of which became subject to income taxation" (*id.* at 416).

case, other taxpayers can be expected to assert similar claims for inflated depletion deductions.

The Federal Circuit is a court of nationwide jurisdiction. It is possible for any taxpayer to pay a disputed tax and bring a suit for refund within the Federal Circuit. Because the oil and gas producers that are affected by the decision in this case are professionally counseled, they can be expected to litigate this issue solely in the Federal Circuit in the future. Further review of the decision of the Federal Circuit is thus warranted becaues of its inconsistency with decisions we have discussed and because of the significant importance of this issue to the public fisc. See, *e.g.*, *United States* v. *Hill*, 506 U.S. at 549; *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. at 138.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

KENT L. JONES
Assistant to the Solicitor General

BRUCE R. ELLISEN
THOMAS J. CLARK
Attorneys

January 1997

☆ U. S. GOVERNMENT PRINTING OFFICE: 1997 417722 40240